

Internal Revenue Service

Department of the Treasury

1100 Commerce Street

Dallas, TX 75242

Number: **201050034**

Release Date: 12/17/2010

Date: September 23, 2010

ORG

ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

UIL: 501.10-00

CERTIFIED MAIL - RETURN RECEIPT REQUESTED

Dear :

We have enclosed a copy of our report of examination explaining why we believe revocation of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter revoking your exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Vicki L. Hansen
Acting, Director EO Examinations

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope

Form 886-A	U.S. Treasury Department-Internal Revenue Service EXPLANATION OF ITEMS	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 20XX12

LEGEND

ORG = Organization name XX = Date Address = address City = city
 State = state County = county CPA = CPA Group Manger = group
 manager Revenue Agent = revenue agent Motto = motto DIR-1 & DIR-2
 = 1st & 2nd DIRECTORS RA-1, RA-2 & RA-3 = 1st, 2nd & 3rd RA CO-1, CO-2,
 CO-3, CO-4, CO-5, CO-6 & CO-7 = 1st, 2^d, 3rd, 4th, 5th, 6th & 7th COMPANIES

Explanation of items issued with the 30 day letter on December 22, 20XX was revised and updated to take into consideration and address the written position provided by the organization dated December 29, 20XX and received on February 4, 20XX as well as issues highlighted by the representative during the unagreed conference with the group manager on February 18, 20XX.

Revocation

ISSUE:

Does the organization satisfy the operational test for a tax exempt organization per IRC Section 501(a) as described in IRC 501(c)(10)?

Is there inurement or private benefit to officers and/or directors?

FACTS:

ORG(ORG) was granted a charter from the CO-1 on September 1, 20XX.

ORG filed its articles of incorporation with the Secretary of State of State. It was registered with the effective date of 9/18/20XX. The articles of incorporation dated and signed on 9/17/20XX stated its purpose as Restaurant/Bar Society Club.

In a letter written to the Internal Revenue Service (IRS) with its application for exemption, organization stated that the articles of incorporation was amended to include;

- a. It is a fraternal organization.
- b. No part of its net earnings of the organization shall inure to the benefit of or be distributable to its members, trustees, officers or other private persons, except for reasonable compensation for services rendered.
- c. No substantial part of the activities shall be the carrying on or propaganda, or attempting to influence legislation. It shall not participate or intervene in any political campaign.
- d. Upon dissolution, assets shall be distributed for one or more exempt purposes per IRC 501©(3).

By-laws revised on August 20XX stated that the object of the organization to be;

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- a. To promote the social and moral welfare of its members.
- b. To encourage human and spiritual values of life.
- c. To cooperate in all charitable and civic appeals.
- d. To provide through CO-1, a practical means to form meaningful friendships, altruistic services and to build better communities.
- e. To promote true patriotism to our Country and to be a loyal Motto.
- f. To cooperate in creating and maintaining sound public opinion and high standards which make possible the promotion of goodwill and community concern for others.
- g. To promote educational for its members, their family and community.

By-laws further stated the following;

A chartered club **shall hold regularly scheduled meetings not less than one(1) each month**, on such day and at such place as shall be determined by the Trustees, for the transaction of business. If a club's regular meeting falls on a legal holiday or eve thereof, the trustees may reschedule the meeting for another day during the affected week or cancel the meeting, provided not more than two(2) regular meetings are cancelled during any given year.

A chartered club may hold such other meetings as the officers or members may desire, and may call special meetings subject to the call of the president. No business shall be transacted at special meeting except that for which such meeting has been called.

A quorum of at least ten members must be present at a meeting in order to transact business.

Article IV states that a chartered club shall hold its annual meeting and election of officers and trustees not earlier than the first week in November and not later than the second week in December. The officers shall serve for one(1) year or until their successors are duly elected by a plurality vote.

Article VI on **membership** in clubs state the following;

1. applicants for membership shall be at least 21 years of age and of good moral character. Application shall be received in writing, signed by the applicant and by a member of the ORG in good standing who recommends the applicant and shall give the applicants name, age residence, occupation and such other information as the chartered club may prescribe.
2. **Applications must be investigated by the Secretary and investigating committee before being balloted on in accordance with the balloting procedures for each chartered club.** The initiation fees for membership shall accompany each application. Should a candidate for membership neglect or refuse to appear for initiation within the period of ninety days after having been properly notified of election, the amount paid for the person's proposition shall be forfeited to the ORG and to the Home ORG.
3. Active members shall maintain regular attendance at meetings and shall actively participate in the activities of the ORG. The Trustees of said ORG shall review semiannually the

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attendance and activity participation record of each member. Each ORG shall prescribe a remedy for members who are not in compliance with this Section 3.

4. Transfers from other Motto ORG are allowed.
5. Per capita tax. All members shall pay dues annually as set by the subordinate ORG.
6. Initiation: a new member processing fee i.e. initiation fee will be charged to each new member.

Copy of L-1024(Application for Tax Exemption) stated its planned activities as follows;

1. Food services: Lunch and dinner for members
2. Entertainment: music, computer games, trivial pursuit will be conducted. Some of the equipment will require pay coins to operate.
Participants will be selected in accordance with the by-laws of the local and CO-2.
3. Charitable activities such as scholarship, parties for Christmas and Halloween for the community children; and other community based activities will be sponsored by the officers of organization with participation by members at large.
Qualifications for membership must be an adult; a person of honorable character and in good health; of sound mind. Annual membership dues is \$. See article IV of By-Laws.

The annual membership fee has been lowered to \$ as stated by DIR-1 during initial interview. He subsequently qualified this statement that the fees were waived for the membership drive in 20XX.

ORG was granted tax exemption per IRC 501(a)(1) as described in IRC 501(c)(10) with a Letter 948 dated 7/28/20XX.

Sample review of the minutes of meetings from 2/1/20XX through 12/20XX are as follows;
20XX – No specific date –

Discussed having a management company run the day to day operations of the Mottos.
Discussed location at Address in City, State for a hall/lodge. Rent to be around \$-\$.
Discussed changing meetings from monthly to quarterly to encourage more members to participate.
Discussed terms of agreement/proposal from CO-3 to use them to manage day to day operations with state agencies, employees, travel, etc.
CO-4 out of City, State will be primary operator of all lottery terminals.

20XX – Members meeting a flop, new members are not willing to pay the \$ to join. Home ORG suggested some type of membership rally.
Required all new members to be accompanied by an old member in order to join Mottos.

6/20XX – Discussed lowering dues to \$ to encourage new members.
June meeting only had 6 people attend.

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9/20XX – Scholarship winners will be awarded \$ in 2 installments of \$ to prevent student from spending all the money in one semester.

8/20XX – None showed up for August meeting. Will try again in October.

10/20XX – No October meeting.

6/20XX – No meeting. 3 people showed up.

9/20XX –Talked about membership drive in the spring.

Discussed buying better chairs for games. The 100 are only lasting 6 months or so.

12/20XX – No meeting No people

Cold and slick outside.

Noted the following during the inspection of the facility located at Address., City State;

- a. Mottos ORG sign is posted on the side of the 2nd floor level of the building;
- b. Open sign posted on the side of the 1st level of the building.
- c. There is a “for members” sign posted at the door or at the window.
- d. There is a buzzer to enter the building.
- e. The entrance room is surrounded by 10 video lottery machines(vlm) along the walls.
- f. There is an enclosed room for an ATM machine.
- g. There is a monitor screen for the surveillance cameras facing outside and inside where the vlm’s are located.

During interview with DIR-1, he provided the following statements;

- a. Hours of operation are; 7AM-3:30AM Mon-Saturday and 1PM-3:30AM on Sundays.
- b. Open 7 days a week.
- c. There are 3 shifts of employees to operate the facility. Only 1 employee is needed per shift.
- d. There is no volunteer labor.
- e. The facility is open to members only.
- f. Guests have to be accompanied by a member and have to apply for membership.
- g. Applicants provide their names and address on a log book of members.
- h. There is no application form to complete.
- i. Employee receives and approves the application. Officers do not review the approval process. Approved member is not formally presented at the quarterly meeting.
- j. There is no logbook of members entering the facility on a daily basis.
- k. Employees check for membership upon entrance at the facility.
- l. Review of the logbook of members showed their names and address.

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- m. Applicant is issued a membership card with a duplicate card kept on the premises.
- n. Membership is currently \$/year. The membership fee was waived in 20XX for the membership drive.
- o. Requirement to be a member is 21 years old and of good character.
- p. Members are required to pay their annual dues, attend meetings and must be active with the organization.
- q. ORG operates 10 vlms at the facility. It owns 3 and 7 owned by CO-4.
- r. ORG provides free drinks and coffee to members. It serves snacks and sandwiches.
- s. The games are computerized and linked to the database of State Lottery Commission.
- t. ORG has a contract with CO-3(CO-3) to manage the day to day operation of the vlm facility for \$/week or \$/year. It is owned by RA-1 (husband of DIR-2-incorporator). CO-3 provides the following services;
 - a. Takes care of security systems such as camera, etc.
 - b. Handles the correspondences with the state agencies.
 - c. Maintenance and equipment repairs.
 - d. Hiring and firing of employees.
 - e. Problems with memberships.
 - f. Cash flow with regards to pay off of jackpot prizes.
- u. CO-5 leases the building facility to ORG for \$/month. The rate was based on the fact that the facility is equipped and ready for use. It is compliant with the state lottery commission and CO-6. CO-5 is owned by RA-1(husband of DIR-2-president and incorporator).

Reviewed copies of two lease contracts with CO-5

- a. Lease contract dated 10/1/20XX
 - i. Location of property leased – Address., City, State
 - ii. Landlord – CO-5 Tenant – Mottos ORG
 - iii. Rental rate of \$/month or \$/year.
 - iv. Electric, gas water and trash is responsibility of tenant
 - v. Term of lease – 5 years from 10/1/20XX through 9/30/20XX
- b. Lease contract dated?
 - i. Location of property leased – Address, City, State
 - ii. Landlord – CO-5 Tenant – Mottos ORG
 - iii. Rental rate - \$/month
 - iv. Water, gas, electric is responsibility of tenant
 - v. Term of lease – 5 years from January 1, 20XX through January 20XX.
 - vi. Contract signed by tenant on 12/20/20XX.

DIR-1 made statements relating to the rental or lease value of property located at Address, City, State from CO-5 in a letter received on 10/20/20XX.;

“I have spent quite some time trying to locate a comparison commercial property that is zoned properly to meet state requirements. I cannot find any that have sold in County, however

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property sold approximately 2 years ago in the adjoining County for \$ for about \$ sq. ft. I have enclosed a business card of a real estate agent(#6) who has helped me try to find comparisons”.

To verify the statement made by DIR-1 on the reasonableness of the \$/month lease value of property in City, State, **a research of current properties on the market on the internet was made on 11/6/20XX.** Google search showed a commercial property on sale as follows;

Location of property for sale: Address, City, State

In town, city limits(map showed **it is 4 blocks away from Address, City,, State which is the current property leased by taxpayer)**

Sale price: \$

Type of property: Commercial/Retail

Size: 11,000 sq. ft.

Other description of property:

-3 level building w/ partial unfinished basement

-additional 41X160 vacant lot for extra parking

-second floor heated with space heater and offers 3 large rooms and bathroom

Realtor: CO-7 #

MLS ID: #

Using the website’s loan calculator amount, various combinations of down payments and interest rates and loan terms are estimated as follows;

- \$/month assuming 5.75% rate @ 30 years w/ \$ down pymnt.
- \$/month at 7.5% interest rate @ 30 years w/ \$0 down payment.
- \$/month at 10% interest rate @30 years w/ \$0 down payment.

On 11/7/XX, research and telephone call with County Assessor’s office(#) revealed the following information;

Property: **Address/. City, State #**

Owner: RA-2 & RA-3

Assessment: \$

To verify if video lottery facility is strictly for the use of members, verification letters were issued to a sample of members and employees.

The sample of 17 members were selected at random from;

- membership list provided by DIR-1.
- Copies of Form W-2Gs issued to winners of video lottery machines >\$.

Sample of 5 current and former employees were selected at random from;

- Copies of Form W-2’s

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Verification letters issued to members and employees total 22.

- a. 5 were returned by the post office as undeliverable(22.7%).
- b. 9 members and 2 employees responded for a total of 11 responses rcvd in writing or over the telephone(50%).
- c. 6 did not respond to the verification letters(27.3%).

Nine members who responded provided the following information;

1. 3(3/9=33.3%)members stated they are members but provided the following;
 - a. They did not submit an application form.
 - b. They were not interviewed for membership.
 - c. They did not attend any meeting or other activity.
 - d. They did not pay membership fees.
 - e. Their purpose in joining the organization were to play the keno and to have fun.
2. 6(6/9=66.6%) individuals who were listed as members or issued a Form W-2G stated they were not members.

3. 9(9/9=100%) respondents stated;
 - a. They did not submit an application form.
 - b. They were not interviewed for membership.
 - c. They did not attend any meeting or other activity.
 - d. They did not pay membership fees.

4. 2 employees responded. They provided the following information;
 - a. There was no sign in sheet to enter the facility.
 - b. They check for the membership card.
 - c. The membership card is required to use the facility or play the machines.
 - d. They did not approve an application form. They just ask the non members to fill out a membership card.
 - e. They are not aware of membership or entrance fees.
 - f. Organization provided free drinks and snacks but charge \$ for sandwiches or pizza.
 - g. They are not aware of any meeting held at the facility.

The responses from the membership list and employees provided the following information;

1. 33% of the respondents who claim to be members simply completed a membership cards but did not submit application form, nor paid a membership fee nor attended a membership meeting.
2. 66.6% of the respondents denied being members of the organization.
3. 100% of the respondents did not did not file an application form nor paid membership fee nor attended a meeting.
4. All the employees who responded checked the membership cards.

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They do not receive and approve the application forms. This is contrary to what DIR-1 stated during the initial interview that employees receive and approve the application forms.

Based upon the above responses, the organization considers anybody to be a member as long as they fill out a membership card or a sign in sheet. They do not require any application form, membership fees or participation in any organization meeting or activity. The filling out of membership card appears to be a disguise to require membership as opposed to having the facility open to the public.

A summary of the response provided by the members and employees are as follows;

	Are you a member?	Submit an application	Interviewed?	Attend Meeting?	Paid memb fee?	Purpose of member
1						
2	No	n/a	n/a			
3						
4						
5						
6						
7	yes	No	no	no	no	To play video games
8	No	No	no	no	no	did not join, just stopped in on way home.
9	No	No	n/a	no	no	she did not apply
10						
11	yes	No	no	no	no	keno
12	no	No	no	no	no	not aware she is a member
13						
14						
15	no	No	no	no	no	did not join. Played the machine 1x
16	no	No	no	no	no	ice tea
17	yes	Card	no	no	no	something to do for fun

	Employees Current or former	Job title	Was there a membership sign sheet	How did You check membership memb card	Is facility for members Only	meetings at the facility
1		Clerk	No		Yes	no
2						
3						
4		cashier host	No	card	obtain card	no
5						

They have membership cards but no application form at the facility.
Employees do not approve the application since there is none at the facility.
They require players to have a membership card or fill out one.

The Limited Video Lottery Act of State provided that no licensed video lottery retailer to have on the premises for which the license was issued more than 5 video lottery terminals except that a

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fraternal society or veteran's organization that is exempt from federal income tax under IRC 501(c)(8) or a domestic fraternal society that exempt under IRC 501(c)(10) or a veteran's organization that is exempt under IRC 501(c)(19). Tax exempt status allows organization to operate up to 10 video lottery machines.

An unagreed 30 day letter was issued on December 22, 20XX. Organization did not respond to the notice. After organization defaulted, the case was processed to mandatory review for issuance of a 90 day letter.

While the unagreed case was in mandatory review, organization contacted the Group Manager, Group Manager, indicating that they have decided to agree with the proposed revocation upon advise of an accountant they consulted.

Per organization's change in position, case was returned to the group for processing of case as agreed revocation and to secure a converted F-1120 returns from time of revocation to current periods.

A signed F-6018 was secured on 3/23/20XX signifying organization's agreement to the proposed revocation. Converted F-1120 returns for 20XX, 20XX and 20XX were secured from organization and received on 6/18/20XX.

On 9/21/20XX, organization requested to consult an attorney on the proposed revocation. Organization was able to consult an attorney on 10/22/20XX but could not afford the fee. Organization was not able to decide on the proposed revocation until after their officers meeting at the end of November 20XX. Representative on 12/10/20XX stated that organization would like to avail of an unagreed conference with group manager. Written protest letter from organization dated 12/29/20XX was received by the IRS office on 2/4/20XX.

LAW:

IRC SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

501(c)(10) Domestic fraternal societies, orders, or associations, operating under the lodge system

501(c)(10)(A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and

501(c)(10)(B) which do not provide for the payment of life, sick, accident, or other benefits.

FINAL-REG, TAX-REGS, §1.501(c)(10)-1. **Certain fraternal beneficiary societies**
§1.501(c)(10)-1. Certain fraternal beneficiary societies

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(a) For taxable years beginning after Dec. 31, 1969, an organization will qualify for exemption under section 501(c)(10) if it —

(1) is a domestic fraternal beneficiary society order, or association, described in section 501(c)(8) and the regulations thereunder except that it does not provide for the payment of life, sick, accident, or other benefits to its members, and

(2) devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.

Any organization described in section 501(c)(7), such as, for example, a national college fraternity, is not described in section 501(c)(10) and this section. [Reg. §1.501(c)(10)-1.]

IRC SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

501(c)(8) Fraternal beneficiary societies, orders, or associations —

501(c)(8)(A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and **501(c)(8)(B)** providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

REGS, §1.501(c)(8)-1. Fraternal beneficiary societies

§1.501(c)(8)-1. Fraternal beneficiary societies

(a) A fraternal beneficiary society is exempt from tax only if operated under the “lodge system” or for the exclusive benefit of the members so operating. “Operating under the lodge system” means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

Revenue Ruling 81-117, 1981-1 CB 346

Section 501.--Exemption From Tax on Corporations, Certain Trusts, etc.

Fraternal beneficiary society; separate support organization.--

An organization that does not conduct any fraternal activities or operate under the lodge system, but does operate exclusively for the benefit of members of certain related domestic fraternal societies operating under the lodge system, does not qualify for exemption under section 501(c)(10) of the Code.

Tax Court of the United States.

FRATERNAL ORDER OF CIVITANS OF AMERICA, FORMERLY NORTH AKRON CIVITAN CLUB,
PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

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Docket No. 27314.
Promulgated November 14, 1952.

EXEMPTION- SECTION 101(3)- FRATERNAL BENEFICIARY ORDER- OPERATING UNDER THE LODGE SYSTEM- BENEFIT PAYMENTS TO MEMBERS OF THEIR DEPENDENTS.- An organization having a membership which lacks a common bond, carrying on no activities which further its written purposes or promote a common object, associating with no other similar organization or 'parent organization' and providing death benefits to any named beneficiary of only one class of members is not a fraternal beneficiary order operating under the lodge system and providing benefits to members or their dependents within the meaning of section 101(3) of the Internal Revenue Code.

District Court, E.D. Missouri, Eastern Division.
WESTERN FUNERAL BENEFIT ASS'N
v.
HELLMICH, Collector of Internal Revenue.
October 28, 1924.

Judge Davis is cited in part and made a determination of the following;

The issue therefore becomes: First, is the plaintiff a fraternal beneficiary society, order, or association operating under the lodge system; or, is the plaintiff a fraternal beneficiary society, order, or association operating for the exclusive benefit of the members of a fraternity itself operating under the lodge system.

There seems to be no question in the case but that plaintiff itself does not operate under the lodge system. The clause 'fraternal beneficiary society, order or association operating under the lodge system' means that whatever the nature of the organization, it must be operated as a lodge in order for the exemption to attach.

By the 'lodge system' is generally understood an organization which holds regular meetings at a designated place, adopts a representative form of government, and performs its work according to a ritual.

The plaintiff, in order to bring itself within the statute, was obliged to establish the fact that it did so operate and this it does not seem to have done.

B.T.A. 713, 1926 WL 459 (B.T.A.)

United States Board of Tax Appeals.
APPEAL OF PHILADELPHIA READING RELIEF/ ASSOCIATION.
Docket No. 5620.
Decided August 3, 1926.

The court case determined that an association, not organized for fraternal purposes, having neither lodges, ritual, ceremonial, or regalia, owing no allegiance to any other authority or jurisdiction, and whose members are engaged in numerous and diverse vocations, though employees of a common employer, is not a fraternal beneficiary association operating under the lodge system, and, therefore, is not exempt from taxation under the provisions of subdivision (3) of section 231 of the Revenue Act of 1918.

OPINION.

Judge Arundell cited in part and made a determination that;

"Perhaps the leading judicial pronouncement as to what constitutes a 'fraternal beneficiary association' is found in the case of *National Union v. Marlow*, 74 Fed. 775, where Judge Thayer, in speaking for the United States Circuit Court of Appeals, Eighth Circuit, and in disposing of the question as to whether the plaintiff was a fraternal beneficiary association and, therefore, exempt from the Missouri insurance laws, stated as follows:

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We must accordingly assume that the words 'fraternal-beneficial' were used in their ordinary sense-to designate an association or society that is engaged in some work that is of a fraternal and beneficial character. According to this view, a fraternal-beneficial society, within the purview of the Missouri statute, would be one whose members have adopted the same, or a very similar, calling, avocation, or profession, or who are working in unison to accomplish some worthy object, and who for that reason have banded themselves together as an association or society to aid and assist one another, and to promote the common cause. The term 'fraternal' can properly be applied to such an association, for the reason that the pursuit of a common object, calling, or profession usually has a tendency to create a brotherly feeling among those who are thus engaged. It is a well-known fact that there are at the present time many voluntary or incorporated societies which are made up exclusively of persons who are engaged in the same avocation. As a general rule such associations have been formed for the purpose of promoting the social, moral, and intellectual welfare of the members of such associations, and their families, as well as for advancing their interests in other ways and in other respects.

In dealing with cases coming under section 231 of the Revenue Act of 1918, the character of the organization must be judged by its articles of incorporation, constitution, and by-laws, or by what other instrument it is governed. *Corley v. Travelers' Protective Association, supra*; *Berry v. Knights Templars' & Masons' Life Indemnity Co., supra*. Search the petitioner's governing regulations as we may, (it is the only instrument which has been offered to us), we are unable to discover, even in a remote degree, a single fraternalistic feature in its organization. It is entirely without any social features. Its membership is made up of individuals whose vocations are as numerous and diverse as the classifications of employment of a great railway system; the section hand, the freight hustler, the brakeman, the conductor in charge of a fast trans-continental train, the locomotive engineer, the train dispatcher, the clerk in the office, all are entitled to membership in the Association for the mere asking, expressed in written application, provided no disability exists; and yet none of these look to the petitioner for any betterment in social and laboring conditions. There is no fraternal object which moves them to seek membership in the Association, but rather the motive is mercenary. The petitioner has neither lodges, rituals, ceremonial, or regalia; and it owes no allegiance to any other authority or jurisdiction. It is not a 'fraternal beneficiary association' operating under the lodge system, within the meaning of section 231(3) of the Revenue Act of 1918, and, therefore, is not entitled to exemption under the provisions of that section.

Judgment for the Commissioner.

Tax Court of the United States.

POLISH ARMY VETERANS POST 147, PETITIONER,
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.
POLISH ARMY VETERANS POST 147 HOME ASSOCIATION, PETITIONER,
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket Nos. 46097, 46098.

Filed August 11, 1955.

In our opinion the Post has not established that it was exempt under the above paragraph. To qualify for the exemption an organization must be fraternal. Fraternal Order of Civitans of America, 19 T.C. 240; Philadelphia & Reading Relief Association, 4 B.T.A. 713. Here only the active members, comprising less than 10 per cent of the total membership of the Post, had a common tie. They, of course, had the bond of having formerly served in the Polish Army. But approximately 90 per cent of the total membership of the Post were social members who were not ex-members of the Polish Armed Forces and who, so far as the record discloses, had nothing in common with the active members or with each other. An organization cannot be classes as fraternal where the only common bond between the majority of the members is their membership in that organization. Fraternal Order of Civitans of America; Philadelphia & Reading Relief Association, both supra.

TAXPAYER'S POSITION:

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DIR-1 was informed and the organization will review the proposed revocation and will consult a professional on the matter.

The original position of the organization prior to the issuance of 30 day letter includes;

- The video lottery machine facility located at City, State is strictly for member's use only.
- The facility is for the members to achieve their goals.
- The lease rate paid for the facility is at market rate.

Organization's written unagreed position dated 12/29/20XX was received on 2/4/20XX and signed by DIR-2. It stated the following positions;

The Mottos ORG wishes to dispute the facts in which you have deemed or organization to be in non-compliance with our 501c.

1st. We dispute the valuation of the lease. It is our position that the calculations used by the Internal Revenue to arrive at a fair lease value were inaccurate. When comparing a location of this kind it cannot be measured to other properties in that city, but must be compared like licensed real estate in the entire State of State. We can provide a current appraisal at your request.

2nd. It is our contention that the survey taken of our members was unfair in that those members were more apt to answer the survey incorrectly or not answer at all due to legalized gambling being new to State, unfortunately some members still believe it to be prohibited in this State. The high number of non responders to your survey reflects this enigma.

3rd. It is our contention that no inurments have taken place within our organization. We understand that a 3rd party is permitted to be reimbursed for a service provided. We contend that the fees paid to CO-3 are reasonable compensation for the amount of service provided.

4th. The lesser offenses that you mention in your letter have been corrected and we continue to strive to correct mistakes made by Officers and Members new to the workings of a Non-profit organization. We continue to help the community in many ways including a yearly college scholarship that to date has allowed 6 students College education that they otherwise could not afford. Based on these disputes, We respectfully ask the IRS to continue to allow us our 501(c) privileges. We will continue to strive to comply with all 501(c) requirements and will meet all the standards that are required by the IRS. We would ask that you continue to monitor us and re-review our records at a future point to verify our determination.

We look forward to our phone conversation scheduled for Thursday February 11, at 10:00 am.

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An unagreed conference with Group Manager was held on February 18, 20XX via teleconference. Present were; CPA and POA, DIR-1, officer, Group Manager and Revenue Agent.

CPA highlighted the following positions taken by the organization;

1. Valuation:

One of the basis used in valuation was the assessment by the county. He indicated that they are usually 60% of deemed market value. Valuation should be based on an appraisal to be done by a licensed local appraiser. Organization will submit an appraisal within 10 days for their appeal.

2. Charitable contribution:

Organization's \$ scholarship fund is more significant if computed on the basis of net revenues and not gross revenues.

3. Meetings:

Organization changed its by-laws to require quarterly meeting vs. monthly meetings. They also intend to provide substantiation that members attended the meetings.

4. Membership sample of survey is not a good representation of its membership;

Members are usually hesitant to respond to the IRS. Organization will provide substantiation for membership participation by its members in its activities.

GOVERNMENT'S POSITION:

Explanation of items issued with the 30 day letter on December 22, 20XX was revised and updated to take into consideration and address the written position provided by the organization dated December 29, 20XX and received on February 4, 20XX as well as issues highlighted by the representative during the unagreed conference with the group manager on February 18, 20XX.

Examination of the F-990 return of ORG for year ending 20XX showed that it did not engage in activities as prescribed for its tax exemption per IRC 501(a) as described in IRC 501(c)(10) for the following;

1. It failed to hold monthly meetings and cancel no more than 2 monthly meetings in a year as prescribed in its bylaws. And more importantly, there is no evidence of any organization meeting held or charitable activity where there was significant attendance by its members. It does not appear that there was an active participation by so called members at organization's activity outside of playing the video lottery machines either in its monthly meetings or any charitable or civic activity. Please note that organization provided copies of membership cards it issued in 20XX with a total number of at least 250. It therefore failed to operate as a lodge system as

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required by IRC 501(c)(10) and IRC 501(c)(8) and as supported by the court case of Western Funeral Benefit Association V. Hellmich 2 F.2d 367, 5 AFTR 5138.

- a. Review of the minutes indicated that it may have held five meetings in 20XX. It stated that there was no meeting in 12/20XX as none showed up and there was no meeting on 6/20XX as 3 people showed up. In 20XX, there were notes for 4 dates where none showed up for 8/20XX and no October meeting for 10/20XX. Bylaws required that it hold a monthly meeting and that no more than 2 meetings be cancelled in a given year.
- b. It did not record the names of officers or members who attended the meetings, where and when the meetings were held. At this point, it cannot be ascertained whether these minutes are simply notes of discussions between a handful of the officers or a regular organization meeting. However, it appears that organization did not meet the required 10 people to comprise a quorum to transact business as required by the bylaws. These minutes of the meetings therefore do not meet the requirement as a bonafide meeting per its bylaws.
- c. There is no evidence that any of the 250 members attended the so called meetings other than the officers and organizers who happen to be same individuals who were contracted to manager the organization. Therefore, there is no significant and meaningful fraternal activity undertaken by the organization and its members.
- d. Verification letters were sent to a sample of members. All(100%) of respondents denied attending an organization meeting nor participated in any organization activity other than play the video lottery machine.
- e. Sample of employees who responded to a questionnaire stated that they are not aware of any organization meeting held at the place. This is not supportive of the statement made by Zachary Jones, officer that the meetings were held at the facility located at Address,. City, State.

2. ORG failed to establish bonafide members with a common calling, common bond or avocation as required by IRC 501(c)(10) and IRC 501(c)(8) and supported by the court cases of Philadelphia Reading Relief Association 4 BTA 713, 1926 WL 459, Polish Army Veterans Post 147 V. Commissioner of Internal Revenue, and Fraternal Order of Civitans of America 19 TC 240.

Audit procedures performed showed that the actual membership to the organization is open to any individual who would like to play the video lottery machine and fills out a membership card. It does not require the filing of an application form that was to be reviewed by the officers of the organization, nor the payment of dues or application fees. As noted earlier, there was no evidence of participation by any of the 250 members with operation or manager of organization's activities or attendance in meetings as required by its bylaws. ORG has completely ignored its own rules for membership as stated in its by-laws.

Organization's failure to implement its by-laws gives and appearance that they were adopted in form but not in substance to obtain tax exempt status.

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This position is supported by the responses from the verification of membership which also contradicted the oral testimony of the officer as far as membership rules and requirements.

3. ORG failed to adopt a representative form of government by failing to hold a meeting and election of officers from the time of its incorporation in 20XX. Review of the minutes of the board meetings failed to establish ever holding such elections. It therefore failed to operate under a lodge system as required by IRC 501(c)(10) and IRC 501(c)(8) as supported by the court case of Western Funeral Benefit Association V. Hellmich 2 F.2d 367, 5 AFTR 5138.

4. ORG's main activity is operating as a retailer of 10 video lottery machines at the facility located at Address,, City, State. Contrary to statements made by the officer, the video lottery machine facility is being operated as a for profit entity by being open to the public. By virtue of gaining status as a tax exempt organization as a fraternal organization per IRC 501(c)(10), it was able to operate 10 video lottery machines as opposed to a for profit business with a limit of operating with 5 video lottery machines.

Its membership requirement to use the facility is merely a disguise as all it takes is to fill out a membership card to enter. There is no requirement for the organization or its officers to review or approve the membership application as there is no need to submit an application form. There is no need to pay a membership fee nor participate in the organization's activities nor attend organization meetings. In other words, even with all the notices and signs that the video lottery machine facility is for members only, virtually anybody can enter and use the organization facility to play the video lottery machine.

In all practical purposes, organization has not operated in a different manner with a for profit business. A determination is therefore made that ORG failed to satisfy the requirements of its tax exemption as a fraternal lodge per IRC 501(a) as described in IRC 501(c)(10).

5. ORG is operating as a shell organization. The operation of its main activity which is the video retail facility was subcontracted to a for profit entity named CO-3(CO-3). CO-3 is owned co owned by DIR-2 who is the founder and officer of the organization. CO-3 takes care of the full operation of the video lottery machine retail facility.

A determination is therefore made that ORG failed to operate and satisfy the requirements of its tax exemption as a fraternal organization per IRC 501(a) as described in IRC 501(c)(10).

6. ORG has set up a scholarship fund for \$ with City High School. However, this is not sufficient to satisfy the charitable or worthy cause in light of the following;

e. Members or officers of ORG are not involved in the scholarship program such as selection of awardees, etc. It merely provides a \$ check on an annual basis. The key is that there is no significant membership or organization participation in this activity.

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f. \$. represents .46% of gross revenues of \$ or 1.43% of net proceeds of \$. It is determined to be of insignificant amount in terms of its gross revenues.

The lack of participation by the membership in the activity fails to show that it is a fraternal organization as cited in the court case of Philadelphia Reading Relief Association BTA 713, 1926 WL 459. It cited that a fraternal organization is, "one whose members having adopted the same or a very similar calling, avocation or profession are working in unison to accomplish some worthy object, and who for that reason have banded themselves together as an association or society to aid and assist one another, and to promote the common cause".

7. Internet research on the commercial property value in City, State showed that the \$/monthly lease with CO-5 is more than 2X the market value. Since DIR-2 is a related party and has a direct or indirect ownership in CO-5, it appears that there is inurement or private benefit which is prohibited for tax exempt organizations per IRC 501(a) as described by IRC 501(c)(10).

CO-7 offered a listing on the internet on 11/6/20XX a commercial property located just 4-5 blocks away from ORG's current leased property. It was offered for sale for \$. It has 3 full floors as compared to ORG's leased space limited to the first floor. The website mortgage calculator estimated monthly payment of \$/month with assumption of 5.75% interest rate and \$ down payment for 30 years. With \$0 down payment, the internet mortgage calculator estimates a \$/monthly payment.

Another basis for making a determination that the \$/monhly lease with CO-5 is more than fair market value is the property tax assessment by the County assessor's office at \$.

Using the internet website loan calculator on CO-7 using \$ (more than double the county assessment value) @ 30 years w/ \$0 down assuming 10.00% interest rate, the monthly payment is \$.

This is a conservative estimate using double the price of the county assessment and at 10% interest rate. Based upon this finding, it appears that the monthly lease rate of the organization for \$/month is more than 2-3x market rate. In addition, please note that organization is only leasing the first floor of the building (not including the 2nd floor). This means that ORG's \$/month is close to 3X the mortgage on the much larger facility in its vicinity.

Therefore, the lease value on the property for \$/month is determined to be excess of its market value and not reasonable.

Also, it is interesting to note that ORG executed the original lease agreement with CO-5 on 10/1/20XX for \$/month for a 5 year period starting on 10/20XX through 9/30/20XX. However, this contract was superseded by another contract sometime in December 20XX which raised the monthly rent to \$.

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Also, another factor which indicates that the \$/monthly lease is in excess of market value is based on the fact that CO-5 does not own the property it leases. County records showed that the owner is RA-2 & RA-3. It means that ORG is paying CO-5 to lease the property from the real owner. It means two layers of rental fee.

Since DIR-2, who is the founder and current president of the ORG, is a direct or indirect owner of CO-5(related party), there appears to be inurement of net earnings of the organization to insiders or related parties and is not devoted to the benefit of the members. This warrants the recommendation to revoke ORG's tax exemption per IRC 501(a) as described in 501(c)(10).

The inurement and private benefit to related party is also a clear violation of its organizational document that was submitted to the Internal Revenue Service when it applied for tax exemption which stated that, "no part of its earnings of the organization shall inure to the benefit of or be distributable to its members, trustee, officers or other private persons, except for reasonable compensation for services rendered".

Based on the above, it is government's position that the tax exempt status of ORG be revoked effective 1/1/20XX.

Government's response to organization's position and dispute of facts on proposed revocation are as follows;

Taxpayer's 1st position:

"We dispute the valuation of the lease. It is our position that the calculations used by the Internal Revenue to arrive at a fair lease value were inaccurate. When comparing a location of this kind it cannot be measured to other properties in that city, but must be compared like licensed real estate in the entire State of State. We can provide a current appraisal at your request".

Government's response:

As the saying goes in the real estate market, "location, location, location". There is no better comparison to a real property market value than one that is located in the same city, business district that is 4 blocks away from the facility being leased by the organization.

Taxpayer's 2nd position:

"It is our contention that the survey taken of our members was unfair in that those members were more apt to answer the survey incorrectly or not answer at all due to legalized gambling being new to State, unfortunately some members still believe it to be prohibited in this State. The high number of non responders to your survey reflects this enigma".

Government's response:

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The sample of members surveyed was taken from a list provided by the organization and video lottery winners who were issued Form W-2G's. Therefore, there is no basis to the position as the survey of membership being unfair. Also, with part of the sample taken from the video lottery winners who were issued Form W-2G's by the organization, how can they fear or believe that gambling is prohibited?

In fact, this position taken by the taxpayer is further evidence that the organization failed to operate as a fraternal organization with members who have a common calling and engaged in fraternal activities. If the organization's so called members were familiar with and engaged in fraternal activities, they would have known that the organization will not engage in an illegal gambling activity and that they should all be proud to convey its activities.

Taxpayer's 3rd position:

"It is our contention that no inurments have taken place within our organization. We understand that a 3rd party is permitted to be reimbursed for a service provided. We contend that the fees paid to CO-3 are reasonable compensation for the amount of service provided".

CPA, pointed out during the unagreed conference with group manager that the valuation of the leased facility should be based on an appraisal by a local licensed appraiser. In addition, he pointed out that the assessment value by the county is usually 60% of deemed value.

Government's position:

Inurment is evidenced by the excessive rental rate paid by the organization to CO-5 for \$/month when a similar business facility that is 4 blocks away is on the real estate market that is priced at \$ which converts to a monthly mortgage at \$/month at 5.75% rate with \$ down payment for a 30 year loan. With \$ down payment, the mortgage would have been \$/month.

Please note that this business office building on the market has 3 full floors as opposed to organization's leased space limited to the 1st floor of the building.

Therefore, the excess monthly lease is way above double the market rate and determined to be excessive and represents an inurement of part of the organization's profit to the officers who own CO-5

Taxpayer's 4th position:

"The lesser offenses that you mention in your letter have been corrected and we continue to strive to correct mistakes made by Officers and Members new to the workings of a Non-profit organization. We continue to help the community in many ways including a yearly college scholarship that to date has allowed 6 students College education that they otherwise could not

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afford. Based on these disputes, We respectfully ask the IRS to continue to allow us our 501(c) privileges. We will continue to strive to comply with all 501(c) requirements and will meet all the standards that are required by the IRS. We would ask that you continue to monitor us and re-review our records at a future point to verify our determination”.

Government’s position:

Taxpayer did not identify or clarify what the lesser offenses it is referring to in its protest letter. However, failure to satisfy the operational and activity test as a fraternal organization is no lesser offense per IRC 501(c)(10).

Additional position taken during the unagreed conference with group manager that organization changed its bylaws from having monthly to quarterly meetings.

Government’s position:

The facts stated in this F-886-A are based on what organization provided during the examination phase of the F-990 return. There was no documentation provided during the examination that the by-law was amended.

Even if the by laws were amended to require a quarterly meeting as opposed to a monthly meeting, the important issue is the fact that there was no evidence to show that members attended or participated in these meetings. There was no evidence of membership voting to elect officers, etc.

CONCLUSION:

ORG Inc’s(ORG) membership comprise of around 250 individuals who completed a membership card to play its video lottery machines located at Address., City, State. There was no record to show any member other than the officers and founders attended meetings, take part in its activities outside of playing the video lottery machines. Members failed to vote on a representative group of officers since the time of incorporation. The officers or organization did not review any application form as there was none required to be filed. The members were not required to pay membership or application fee. The members had nothing in common, nor share a common calling nor bond nor a charitable cause or activity to benefit its members. Organization operated a video lottery game facility that is practically open to the public even though it had signs that it is for members only. The above facts showed it failed to satisfy the operational and activity test requirements of its tax exempt status as a fraternal organization. It warrants a recommendation for revocation of its tax exempt status per IRC section 501(a) as described in IRC section 501(c)(10) for a fraternal organization.

ORG did not operate according to its by-laws as follows;

a. It did not recruit, select, process, and approve its members according to its by-laws. Its membership process was undertaken by its employees and not by its members and it only

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required that the members complete a membership card. It also failed to conduct a meeting which included the attendance of its members.

b. It waived the payment of quarterly and annual membership dues or pay initiation or application fees.

c. It did not hold sufficient number of monthly meetings. Please note that organization claimed it revised its bylaws to require quarterly meetings instead of monthly meetings. However, there was no documentation provided during the examination of books and records to support this claim.

d. Its meetings did not have sufficient number of members and officers in attendance as required by the by laws.

e. It did not hold any election of officers on an annual basis.

The above facts showed that ORG failed to operate according to its by-laws and was not operated as a fraternal organization under the lodge system. It failed the operational and activity test. Therefore, the revocation of its tax exempt status per IRC 501(a) as described in IRC 501(c)(10) for a fraternal organization is warranted.

Organization operated a video lottery game facility that is practically open to the public even though it had signs that it is for members only. Membership to the organization boils down to the willingness to fill out a membership card(which is not even an application) to play the video lottery machine and not having to pay a membership due or fee, no requirement to attend or participate in its meetings, the membership not having to be reviewed or approved by the organization or its officers. It operated as and no different from a for profit entity. By virtue of its tax exempt status, it gained an unfair advantage of being able to operate with 10 video lottery machines as opposed to a for profit video lottery machine operator which is limited by the State law to 5 video lottery machines. This unfair advantage translates to more funds available for payment to entities owned by the officers for its lease through CO-5 and management contract with CO-3. Operating the fraternal lodge as a video lottery machine to the public warrants the revocation if its tax exempt status per IRC 501(c)(10).

ORG's main and only activity is the retailer of video lottery games. The organization subcontracted the operation and management of its video lottery games to CO-3, Inc.(CO-3). CO-3 manages the facility which includes the hiring and firing of employees, filing of documents with state and local agencies, maintenance of its facilities, etc. Therefore, none of the organization's members or officers is actively engaged in the operation in a significant or meaningful manner. CO-3 is a for profit entity that is owned by its founders and officers. It appears that ORG is operating as a for profit retailer of video lottery machines for the benefit of its officers and founders rather than as a fraternal organization warrants the revocation of its tax exempt status per IRC 501(a) as described in IRC 501(c)(10).

ORG's lease agreement with CO-5 for \$/month appears to be 2-3X market rate for a commercial property in City, State. Research of the internet showed a commercial property in the market

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which is 3-5 blocks away from ORG's facility priced at \$. It has 3 floors with 11,000 square feet as compared to ORG's facility at 1st floor only. Estimated monthly mortgage payment with \$0 down at 7.5% for 30 years is \$. Even with additional expenditures to make it compliant for purposes of a video lottery machine operation, the monthly lease should not balloon to \$/month. Since CO-5 is directly or indirectly owned by RA-1(husband of DIR-2-founder and current president of organization), it represents inurement and/or private benefit. It is a clear indication that net earnings of the organization are not exclusively devoted to fraternal or charitable purpose and therefore warrants the revocation of its tax exempt status per IRC 501(a) as described in IRC 501(c)(10).

The recommendation to revoke the tax exemption status of ORG per IRC 501(a) as described in IRC 501(c)(10) for a fraternal organization of ORG be effective 1/1/20XX.

Upon revocation of ORG's tax exempt status, it will be required to file F-1120 return as a for profit entity.

The position is supported by the following court cases;

Fraternal Order of Civitans of America 19 TC 240
Philadelphia Reading Relief Association BTA 713, 1926 WL 459
Polish Army Veterans Post 147 V. CIR 24 TC 891
Western Funeral Benefit Association V. Hellmich 2 F/2d 367, 5 AFTR, 5138
National Union V Marlow, 74 Fed 775